

November 2008

Honorable Mayor, City Council,
And Citizens of the City of Carlsbad
City of Carlsbad
1200 Carlsbad Village Drive
Carlsbad, CA 92008

**City Treasurer Letter of Transmittal
2007-2008 Annual Report of Investments**

I am pleased to present the Annual Report of Investments for the City of Carlsbad for the fiscal year ended June 30, 2008 (FY 07-08). The report is intended to provide reliable information as a basis for reviewing portfolio performance and making management decisions. It also provides an archival reference.

The City Treasurer is charged with the design of an effective cash management and investment program for the City of Carlsbad and all of its agencies. Among other activities, this includes arranging for banking services; forecasting all cash receipts and expenditures; investing all inactive cash; managing investment risk exposures; and reporting all investment activities.

This report summarizes and analyzes the activities of the investment portfolio for FY 07-08. Total portfolio assets, investment portfolio relative to total city assets, source of portfolio assets, asset allocations, yield achieved, unrealized gains and losses, and cash revenues are presented. To give perspectives to these measurements, a summary of movements in global and U.S. economic, as well as market interest rates are provided for the fiscal year ended June 30, 2008. Comparisons are also made with the preceding fiscal years. Finally, a statement is offered regarding the prospects for the fiscal year 2008-2009 commencing July 1, 2008.

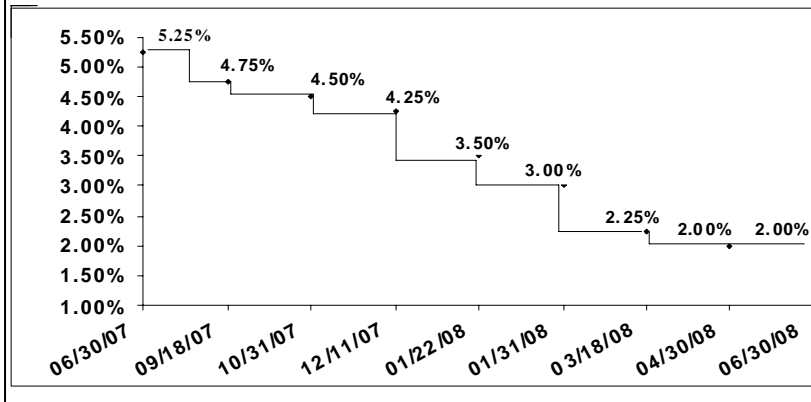
Harold (Mac) McSherry
City Treasurer

CITY TREASURER

ANNUAL REPORT OF INVESTMENT PORTFOLIO FOR THE FISCAL YEAR ENDED JUNE 30, 2008

FY07-08 MARKET REVIEW

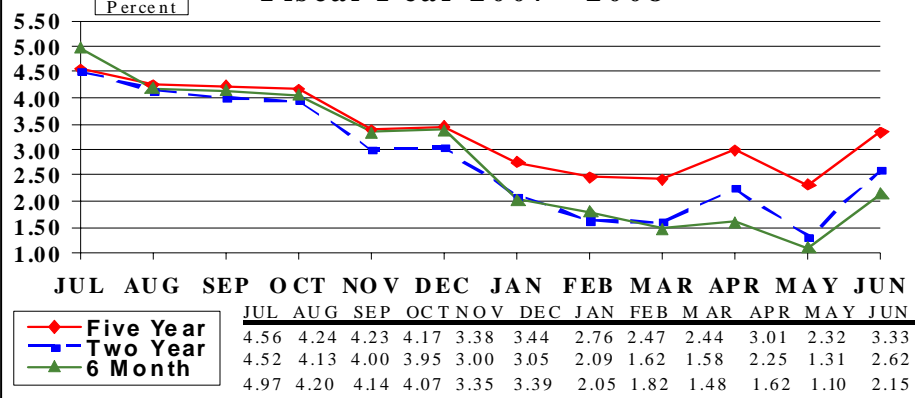
Federal Funds Target Rate FY 07-08



Federal funds rate is a key money market rate that correlates with rates of other short term credit arrangements. It is the interest rate that banks charge each other for overnight loans. In fiscal year 07-08, the Federal Reserve reduced the federal funds rate from 5.25% to 2.00%.

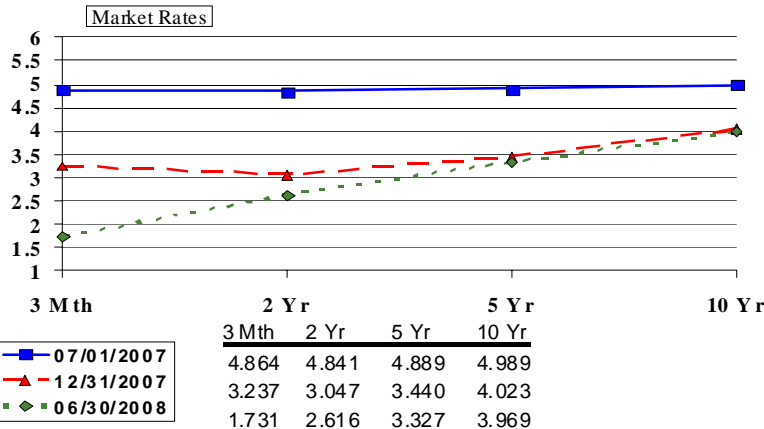
Changes in short-term market interest rates are usually affected by the actions of the Federal Reserve. Six-month, two year, and five year market rates decreased substantially over the course of the fiscal year.

SHORT-TERM INTEREST RATES U.S. Treasury Instruments Fiscal Year 2007 - 2008



YIELD CURVE

7/01/07, 12/31/07, 6/30/08



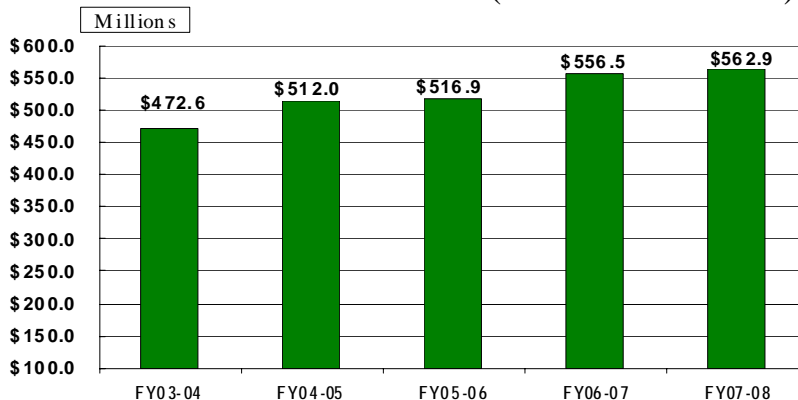
The yield curve is a graphic presentation of the difference between short-term and longer-term interest rates of U.S. Treasury instruments on a given day. Financial analysts use it to assess the market's expectation of recession or inflation. The normal shape of the yield curve has a moderately upward slope, with short-term rates lower than longer-term rates. If the upward slope steepens, the financial

markets believe inflation may occur. An inverted yield curve is when short-term market rates are greater than longer-term market rates. An inverted curve indicates that the financial markets expect a slower economy, if not a recession. As of 06/30/2008 the yield curve shows a relatively moderate upward slope.

PORTFOLIO ANALYSIS

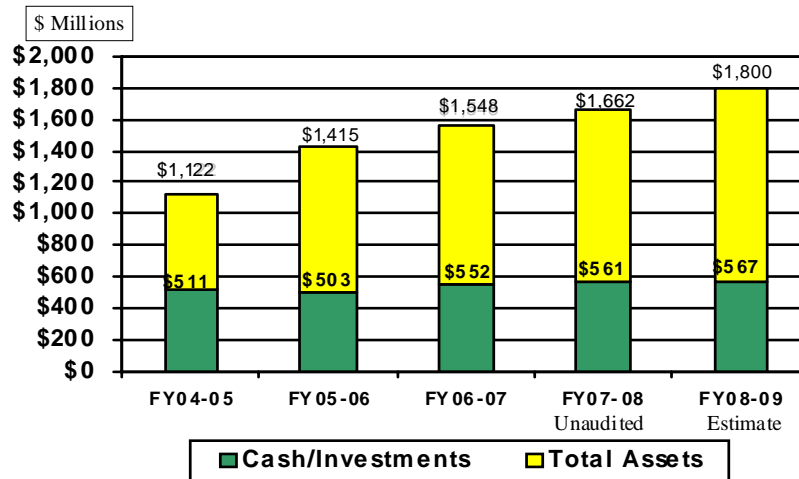
INVESTMENT PORTFOLIO

Dollar Amount of Assets (Fiscal Year End)



Total assets in the investment portfolio stood at \$562.9 million at the end of the fiscal year 07-08, a \$6.4 million increase. This increase includes but is not limited to interest earned, loan proceeds, and revenues in excess of expenses.

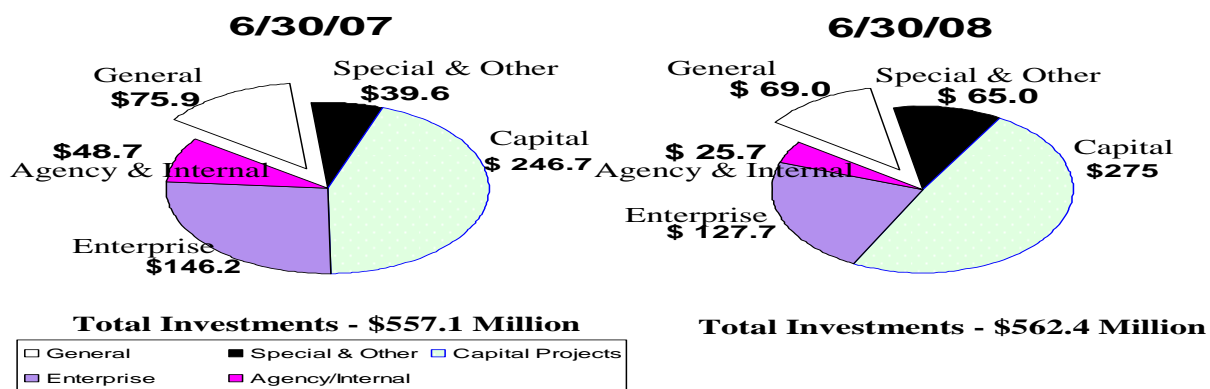
CASH & INVESTMENTS RELATIVE TO TOTAL ASSETS OF CITY AND ITS AGENCIES*



*Source: Comprehensive Annual Financial Report. Note: Total Assets of City and its Agencies is an estimated amount for FYS 08 & 09

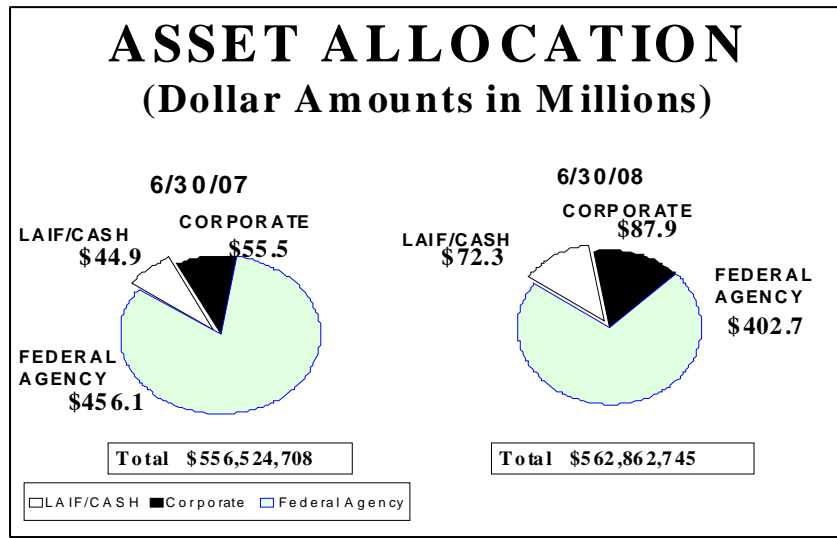
The City publishes a Comprehensive Annual Financial Report (CAFR) at the end of each fiscal year. Among other information, CAFR presents a balance sheet showing the total assets owned by the City and all its agencies. At the end of FY 07-08, cash and investments managed by the City Treasurer represent 31.5% of all assets reported by the City and its agencies.

SOURCE OF POOL ASSETS (Dollar Amounts in Millions)



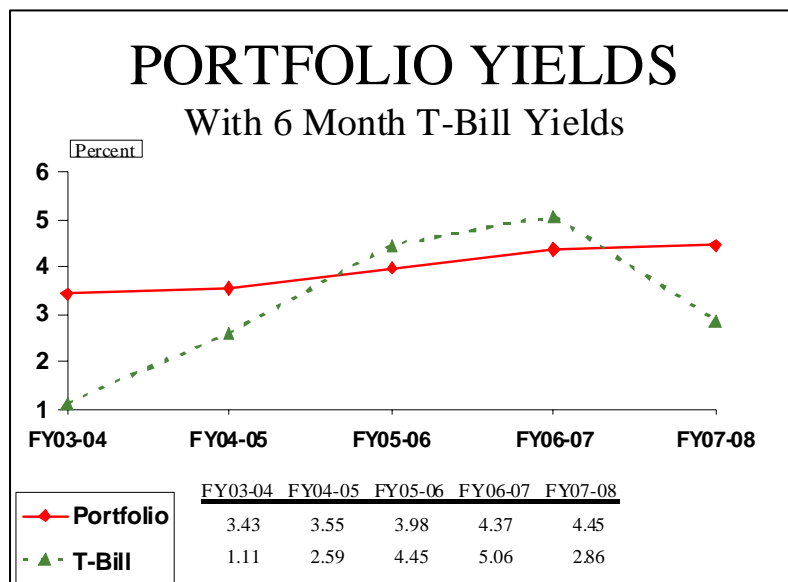
The portfolio is an internal investment pool that uses the inactive cash from the various funds of all City agencies, including the City, the Water District, and the Redevelopment Agency. The top three sources of portfolio assets are the Capital Projects fund (\$275 million, 49% of the total), followed by the Enterprise fund (\$127.7 million, 23% of the total), and the General fund (\$69 million, 12% of the total). Together, these three funds account for 84% of total portfolio assets.

Investments are made in financial instruments authorized by the City's Investment Policy and the California State Government Code. With the exception of bank deposits and deposits in the California State Local Agency Investment Fund (LAIF), all investments are in fixed-income instruments with known maturity dates.



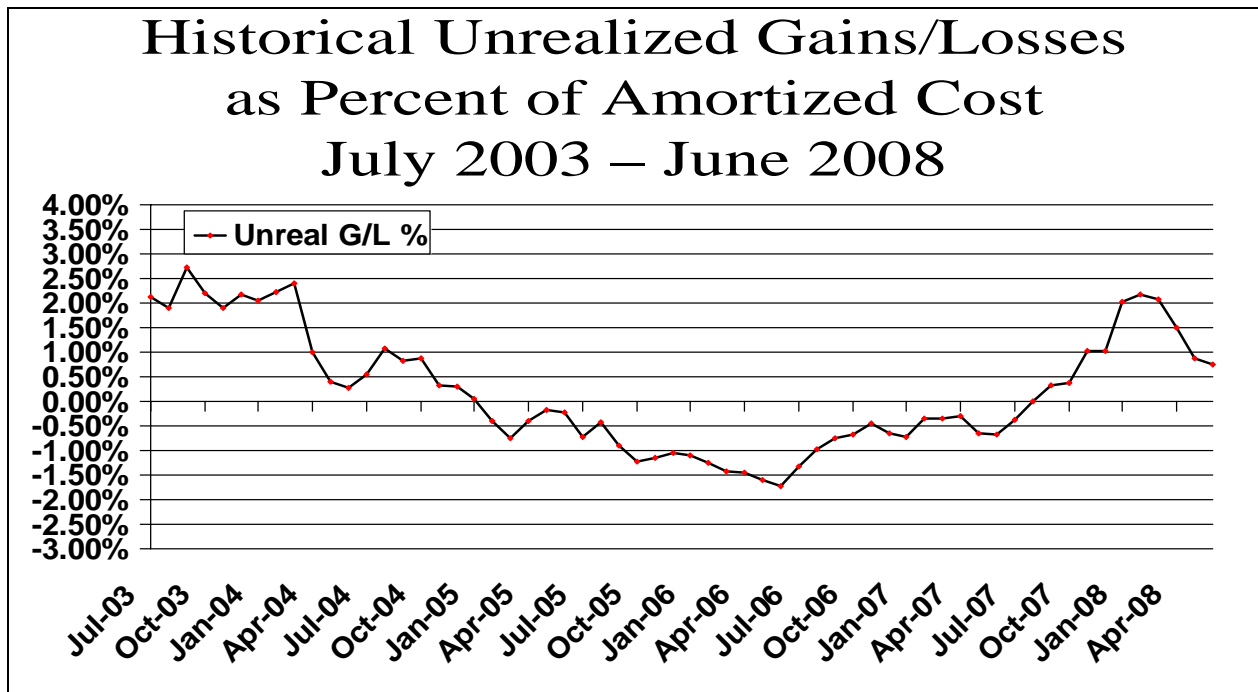
At the end of FY 07-08 (June 30, 2008), 72% of portfolio assets were invested in federal agencies, 15% in corporate notes, and 13% in LAIF and cash. The allocation of assets to federal agencies decreased, while the allocation to corporate notes, cash and LAIF increased from the previous fiscal year. Within the asset category

of federal agencies, investments in the Federal Home Loan Bank, the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, and the Federal Farm Credit Bank, constituted 33%, 20%, 12%, and 5% of the total, respectively. Federal agencies are creations of the U. S. Congress and include agencies and government-sponsored enterprises.



The average return of the portfolio for FY 07-08 increased to 4.45% from 4.37% the year before. The portfolio yield is heavily influenced by changes in short-term market interest rates since approximately 22% of total investments were required to mature within one year. The average interest rate for six-month U.S. Treasury Bills decreased to 2.86% from 5.06% the previous year.

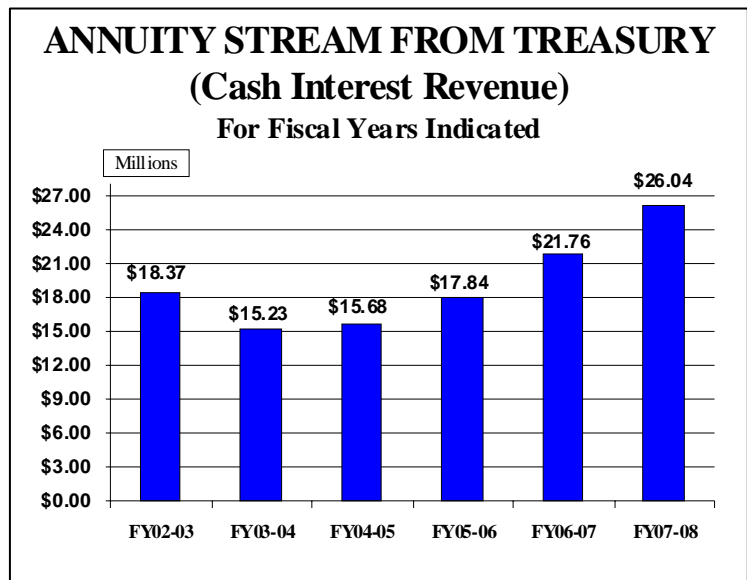
This graph shows the percent change in value of the portfolio over the last several years. Investments gain and lose value subsequent to purchase because of changes in market interest rates. When market interest rates decrease, investments made earlier at higher rates will gain value. The reverse is true when market interest rates increase. Accountants refer to these changes in value as unrealized gains and unrealized losses; newspapers report them as paper gains and paper losses. The gain/loss is not recognized until the investment is sold. Changes in value caused by changes in market interest rates are normal and are expected.



With a buy and hold policy, an objective of the City's Investment Policy is to achieve an average market rate of return over the economic cycle. The success in achieving this objective can be approximated with having unrealized gains and losses that are relatively equal over time. Tracking and measuring unrealized gains and losses could also reveal any presence of high-risk investments in the portfolio. The changes in asset values shown in the graph indicate that portfolio investments are within the acceptable interest rate risk identified in the City's Investment Policy.

The total portfolio had virtually no unrealized gain or loss on June 30, 2008. An unrealized gain of approximately 2% occurred in March 2008, but due to sharp increases in called bonds and lower interest rates, the gain decreased. It is likely that this downward trend will continue in FY 08-09 as investments with higher interest rates are called and reinvested at today's lower market rates.

Cash income from portfolio investments represents an annuity stream of revenues from the Treasury. This annuity stream totaled \$26.04 million, an increase of approximately \$4.3 million from the previous fiscal year. Of the total cash interest revenues earned by the portfolio in FY 07-08, over \$2.8 million was credited to the General Fund. Cash income is a function of assets in the portfolio, the market interest rates at the time of the investments, and the interest payment schedules of the issues.



FY 08-09 PREVIEW / FORECAST

National and international economic forces are the primary influences on market interest rates.

Global Economy

The global economy is experiencing a very sharp decline. The North and South American, European, and emerging economies are expected to slow significantly. Global growth is forecast to decline to 2.5% percent this year. China, India and Russia the fastest growing Asian economies last year, will continue to slow significantly during the spring of 2009. The United States economic growth will be flat in the second half of 2008, and is expected to remain so in 2009. Emerging market economies will decline even faster than the industrialized economies.

Inflation globally is about 3.7%, emerging nations about 2.7%, and the United States is currently 4%. Rising food and fluctuating oil prices are contributing to lower economic growth and heightened inflation concerns world wide. Food prices will continue to increase due in part, to the increasing use of corn and other foods as a bio-fuel. Slower economies reduce food subsidies to poorer nations.

U.S. Economy

It is anticipated that domestic economic growth will continue to decline. The U.S. is probably in a recession which will likely last into the spring of 2009. This will cause the Federal Reserve to lower the federal funds rate still further. It is widely anticipated that the Federal Reserve will decrease the fed funds rate 100 basis points by fiscal year ending June 30, 2009. Governments will face significant decreases in personal and corporate tax revenues with no corresponding decrease in Congressional spending. This will result in increased borrowing by the U.S. (and Europe) at higher rates of interest, possibly putting the Federal Reserve in the position to have to increase interest rates even while the economy slows. Long term market rates will increase faster than short term rates resulting in a steeper yield curve.

City of Carlsbad

Approximately \$97 million of investments with fixed maturity dates will mature in FY 08-09. An additional \$83 million will likely be called due to lower interest rates. Available proceeds from these investments will be reinvested at market rates significantly lower than the maturing and called investments. Yields on City LAIF investments will decrease slightly as interest rates decline.

At the end of FY 07-08, LAIF investments had a yield of 3.12%, and all other investments had a yield of 4.03%. I anticipate LAIF investment yield will decrease to 2.5% by the end of the FY 08-09. Yields on investments other than LAIF will decrease below 4% due to higher yielding investments being called and reinvested at lower yields.

Throughout the fiscal year ending June 30, 2008 the yield of the total portfolio averaged 4.45%. In fiscal year ending June 30, 2009, the total portfolio is projected to have an average yield of 3.85%.

Total assets in the investment portfolio stood at \$563 million at the end of FY 07-08. I anticipate a very slight increase in FY 08-09. Interest revenue earned from portfolio investments in FY 08-09 should approximate \$21 million. Property tax revenues and transient occupancy tax (TOT) revenues are expected increase by 4%. Sales tax is expected to decrease by 1%.

APPENDICES TO ANNUAL REPORT OF INVESTMENT PORTFOLIO

APPENDIX A: RISK MANAGEMENT AND DISCLOSURE

All investments are exposed to risk of some type. The objective of risk management is to identify the risks involved and establish acceptable levels of risks that are consistent with the City's investment objectives. Risk management includes managing, measuring, monitoring, and reporting the various risks to which portfolio investments are exposed.

Portfolio investments are exposed to the following types of risks:

- A. Credit risk.
 - a. Custodial credit risk.
 - a) Investments.
 - b) Deposits.
 - b. Default credit risk.
 - c. Concentration credit risk.
- B. Interest rate risk.
- C. Event Risk.

As of June 30, 2008, the portfolio had the following investments and cash in its internal investment pool.

<u>Investment</u>	<u>Maturities</u>	<u>Market Value</u>	<u>Market Value Gain (Loss)</u>
U. S. agencies	July 2008 - June 2013	\$405,753,000	\$3,400,819
Corporate Notes	July 2008 – May 2013	88,035,000	320,343
Certif. of Deposit	July 2008 – March 2009	33,000	--
LAIF		67,762,000	(3,000)
Sweep accounts		3,868,000	--
Cash accounts		664,000	--
Total		<u>\$566,115,000</u>	<u>\$ 3,718,162</u>

Disclosures

Custodial Credit Risk (Investments). The City uses a third party custody and safekeeping service for its investment securities. The Union Bank of California (UBC) is under contract to provide these custodial services. Custodial credit risk is the risk that the City will not be able to recover the value of its investments in the event of a UBC failure. All City investments held in custody and safekeeping by UBC are held in the name of the City and are segregated from securities owned by the bank. This is the lowest level of custodial credit risk exposure.

Custodial Credit Risk (Deposits). The City maintains cash accounts at Wells Fargo Bank (WFB) and UBC. At the conclusion of each business day, balances in these accounts are “swept” into overnight investments. These overnight investments are pooled and collateralized with either U. S. government securities or U. S. agency securities. The California Code authorizes this type of investment. A small amount of cash is not swept from the WFB checking accounts to cover checks that may be presented for payment. Amounts up to \$100,000 are FDIC insured.

Default Credit Risk. Default credit risk is the risk that the issuer of the security does not pay either the interest or the principal when due. The debts of most U. S. agencies are not backed by the full faith and credit of the federal government; however, because the agencies are U. S. Government-sponsored, they carry AAA credit ratings. The default credit risk of these investments is minimal.

California state code limits investments in medium-term corporate notes to the top three credit ratings (AAA, AA, and A). It is the City’s policy, however, to limit investments to the top two credit ratings (AAA and AA). As of June 30, 2008, two investments equal to approximately .9% of the investments in medium-term corporate notes had a credit rating below the AA limit set by the City’s Investment Policy. These investments were made when the credit ratings were either AAA or AA. California State Code and the City’s Investment Policy allow the City Treasurer to determine the course of action to correct exceptions to the Policy. It is the intent of the City Treasurer to hold these investments in the portfolio until maturity unless events indicate a sale should be made. The default credit risk for corporate notes with a credit rating of single A is greater than the default risk of U.S. federal agencies or LAIF, but is considered by the City Treasurer to be within acceptable limits for purposes of holding to maturity. A credit rating of single A is within State code requirements.

The Local Agency Investment Fund (LAIF) is an investment pool managed by the California State Treasurer. Its investments are short-term and follow the investment requirements of the State. As of June 30, 2008, the average maturity of the LAIF investments was 191 days. The State Treasurer does not contract for a credit rating to be assessed for LAIF. California State Code section 16429.3 specifically excludes LAIF

deposits from being transferred, loaned, impounded or seized by any state agency or official. The default credit risk of LAIF is minimal.

Concentration Credit Risk. Concentration credit risk is the heightened risk of potential loss when investments are concentrated in one issuer. The California State Code does not identify a specific percentage that indicates when concentration risk is present for any one issuer. The State Code does, however, require that total investments in medium-term corporate notes of all issuers not exceed 30% of the portfolio. As of June 30, 2008, approximately 17% of the City's total portfolio investments were in medium-term corporate notes.

For concentration of investments in any one issuer, the City's Investment Policy requires that no more than 5% of investments in corporate notes be in any one issuer. There is no similar requirement in either the State Code or the City's Investment Policy for U. S. agencies. As of June 30, 2008, no investments in any one corporate issuer exceeded 5% of total portfolio investments.

Interest Rate Risk. Interest rate risk is the risk that investments will lose market value because of increases in market interest rates. A rise in market interest rates will cause the market value of investments made earlier at lower interest rates to lose value. The reverse will cause a gain in market value. As of June 30, 2008, the portfolio had a .7% gain in market value.

The City's investment policy has adopted two means of limiting its exposure to market value losses caused by rising market interest rates: (1) Limiting total portfolio investments to a maximum modified duration of 2.2, and (2) requiring maturing investments within one year be equal to an amount that is not less than 2/3 of the current operating budget (\$187,100,000). As of June 30, 2008, the modified duration of the portfolio 1.86 was within the required maximum of 2.2. Investments maturing within one year were \$159,800,000, exceeding the required minimum of \$124,700,000. The City's exposure to interest rate risk is within acceptable limits.

Event Risk. Event risk includes the chance that something unexpected will impede the ability of an issuer of a security to meet its obligations. These types of risks are usually short in duration, but can impair the City's ability to communicate with or use banking services. Such an event could cause a delay in collecting securities which have matured. Security risks are also within this category.

APPENDIX B: PORTFOLIO ACTIVITIES FOR FISCAL YEAR ENDED JUNE 30, 2008

The City's portfolio balance increased 1.1% from \$556.5 million to \$562.9 million in fiscal year 2007-08. The increase of \$6.4 million does little to show the volume of cash that flows in and out of the portfolio in the course of one fiscal year. The following table illustrates that the City Treasurer managed over two billion dollars of cash inflows and cash outflows which prompted investment decisions during fiscal year 2007-08.

Cash Flows:

Bond Maturities	\$ 122,206,000
Bond Calls	186,835,000
Bond Sales	--
LAIF Withdrawals	269,596,000
Sweep Withdrawals	636,923,000
Interest Income	26,037,000
Bond Purchases	286,574,000
LAIF Investments	301,335,000
Sweep Investments	633,246,000
Cash Investments (net)	<u>(210,000)</u>
Total	\$ <u><u>2,462,542,000</u></u>